COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

At Richmond, July 26, 2000

APPLICATION OF

APPALACHIAN POWER COMPANY CASE NO. PUE990716

To revise its fuel factor
pursuant to Va. Code § 56-249.6

ORDER ESTABLISHING 1999-2000 FUEL FACTOR

On October 20, 1999, Appalachian Power Company, d/b/a/ American Electric Power ("Apco" or "the Company"), filed an application, testimony and exhibits in support of its proposal to decrease its currently operative fuel factor from 1.482¢/kWh to 1.325¢/kWh, effective with bills rendered on and after December 1, 1999. The proposed fuel factor reflected the Company's proposal to include the costs of sulfur dioxide ("SO_2") emission allowance costs in the fuel factor, costs which it will incur after January 1, 2000, when it burns coal to produce electric energy for its Virginia customers. Apco also proposed to revise its current Definitional Framework of Fuel Expenses ("Definitional Framework") to accommodate the inclusion of the SO_2 emission allowance costs in the Company's fuel factor.

By Order dated November 2, 1999, the Commission established a procedural schedule, required the Company to provide notice of its application to the public, and set a hearing on the proposed fuel factor to be held on December 15, 1999. The Commission ordered a fuel factor of 1.297¢/kWh to go into effect on an interim basis with bills rendered on and after December 1, 1999. The interim factor was based upon projected annual fuel expenses exclusive of estimated SO_2 emission allowance costs. By Order dated November 8, 1999, the Commission adjusted the interim fuel factor based on a revised estimate of the deferred fuel balance and the discovery of a computational error that was made in determining the initial interim fuel factor. The

Commission amended its Order of November 2, 1999, to state that an interim fuel factor of 1.339¢/kWh is appropriate and should go into effect with bills rendered on and after December 1, 1999.

On December 1, 1999, Staff filed a motion requesting a general continuance. On December 2, 1999, the Old Dominion Committee for Fair Utility Rates ("the Committee") filed a motion in support of Staff's request for a continuance.[1] Apco filed a response on December 2, 1999, stating that it did not oppose a reasonable extension of the procedural schedule, but it did not believe a general continuance of the case was necessary. Apco proposed that the Commission establish a new procedural schedule in order to avoid an unnecessary delay of this proceeding.

Also on December 2, 1999, Staff filed a motion to strike ("Motion to Strike") the portion of the Company's application and supporting testimony concerning Apco's proposed revision to the Definitional Framework to allow fuel factor recovery of SO_2 emission allowance costs. Staff contended that the recovery of SO_2 emission allowance costs through the Company's fuel factor was prohibited by the Stipulation adopted by the Commission in Case No. PUE960301 ("Stipulation"), which governs the Company's rates and services for the period January 1, 1998, through December 31, 2000 ("Plan Period").[2]

In an Order issued December 3, 1999, the Commission granted Staff's motion to continue the case generally until the Commission ruled on the issue of the treatment of SO_2 emission allowance costs.[3] On December 9, 1999, Apco filed a Response in Opposition to Staff's Motion to Strike ("December 9 Response"). On December 14, 1999, Staff filed a Reply to the Company's December 9 Response.

By Order dated January 27, 2000, the Commission denied Staff's Motion to Strike and

---

[1] The Committee had filed a notice of protest on November 3, 1999.

[2] The Stipulation was entered into by Apco, the Staff, the Division of Consumer Counsel of the Office of the Attorney General, and the Committee.

[3] The original hearing date of December 15, 1999, was retained for the purpose of hearing testimony from public witnesses. The hearing was held as scheduled, and no public witnesses appeared.

Apco's request for a discovery cut-off date. The Commission concluded that a hearing should be established to consider the Company's application, including its request to revise its Definitional Framework in order to permit SO_2 emission allowance costs to be recovered through the fuel factor. The Commission set a hearing date of April 11, 2000, and established a revised procedural schedule for the filing of testimony. The Commission directed Staff to investigate the reasonableness of Apco's request and to file a report by March 24, 2000, and directed Apco to file by April 5, 2000, any testimony it expected to introduce in rebuttal to all prefiled direct testimony and exhibits.

As directed, Staff filed the testimony of its witnesses on March 24, 2000, and Apco filed the rebuttal testimony of its witnesses on April 5, 2000. On April 7, 2000, Staff filed a motion for leave to file supplemental testimony, which testimony addressed the treatment of SO_2 emission allowance costs in other states.

Shortly before the evidentiary hearing was to be held, the Commission was informed that newspaper notice of the Company's application had not been published in *The Roanoke Times*. Therefore, by Order dated April 17, 2000, the Commission directed Apco to publish notice of the application in that newspaper. Such notice was to inform the public that the hearing in this matter had been held, but if any interested party requested a hearing, the hearing would be reconvened. The Commission also invited interested parties to submit comments, notices of protest, protests, and testimony. None of the aforementioned was filed.

The hearing was held on April 11, 2000. The Commission Staff, Apco, and the Committee participated at the hearing. The Commission heard evidence primarily concerning the issue of whether the Company should be allowed to recover its SO_2 emission allowance costs through its fuel factor. The Committee also raised two other issues relating to the fuel factor that it requests be addressed in the future, further discussed below. At the conclusion of the hearing, the Commission provided the parties and Staff an opportunity to file post-hearing briefs simultaneously on the issue of the inclusion of SO_2 emission allowance costs in the fuel factor. Post-hearing briefs were timely filed by the Company, Staff, and the Committee.

In its Memorandum in Support of its Application, Apco rebuts Staff's argument that the Stipulation entered into in Case No. PUE960301 bars any revision to the Definitional Framework. Apco contends that SO_2 emission allowance costs are fuel costs and, since the statute permits the recovery of fuel costs, the Company is merely requesting that the Definitional Framework be amended (with respect to the proper accounting treatment of emission allowance costs) to clarify something that otherwise is allowed. Apco adds that its Definitional Framework was adopted long before the Clean Air Act Amendments of 1990 ("CAAA"), and since this is the first case in which Apco's emission allowance costs are at issue, it is appropriate that its Definitional Framework be revised at this time to reflect the emission allowance costs.

In response to Staff's argument that SO_2 emission allowance costs are not fuel costs, the Company contends that the proper way to determine whether a particular cost is appropriate for fuel factor recovery is to consider its function. The Company states that although the allowances themselves are represented by paper certificates, the cost of allowances is part of the cost of the coal since coal cannot be burned and the generator will not run without emission allowances. Moreover, the Company states, the cost of coal and the cost of emission allowances directly track each other since the emission allowance is consumed when the coal is burned. As such, Apco argues, emission allowance costs are a component of fuel and are properly recoverable through the fuel factor.

In its brief, Staff maintained that a change in Apco's Definitional Framework would violate the Stipulation's clear requirement that "[t]he Company's fuel factor and deferred accounting mechanism shall continue under current regulation." Staff states that when, in 1984, the Commission adopted Staff's recommended revision to Apco's Definitional Framework, the Commission stated that "fuel costs recoverable through the fuel factor shall henceforth be in conformity with the following [Definitional Framework]."[4] Staff further notes that the

[4] Staff Post-Hearing Brief at 6, citing *Commonwealth of Virginia, ex. rel. State Corporation Commission, Ex Parte, in re: Investigation to determine appropriate tariffs pursuant to Code § 56-249.6 and PURPA § 210 for Appalachian Power Company*, Case No. PUE840003, Order Setting Fuel Factor and Cogeneration Rate (Mar. 21, 1984).

Definitional Framework lists the accounts to which certain fuel costs should be assigned, and, to its knowledge, Apco has never recovered a fuel cost that was not assigned to an account specifically listed in its Definitional Framework.

Staff maintains that SO_2 emission allowance costs are not fuel costs. Staff states that emission allowances are not intrinsically tied to fuel in that they are not a physical fuel, and they are not physically required to burn fuel. Responding to Apco's argument that the statute permits the recovery of emission allowance costs because they serve a fuel-like function, Staff counters that lime and calcilox are used to remove SO_2 from flue gas stack emissions from some generating units and are consumed in proportion to fuel burned, and these costs have been excluded as a fuel cost.[5] Staff also points out that fuel handling and fuel analysis costs are just as closely related to fuel as emission allowance costs, and also vary in proportion to the quantity of fuel burned, and these costs are not and never have been recoverable through the fuel factor.

Staff contends that SO_2 emission allowance costs are instead environmental costs that are properly recovered through base rates. More specifically, Staff states that emission allowance costs are the costs of complying with the requirements of Title IV of the CAAA, which limit the amount of SO_2 that may be emitted into the atmosphere. Staff explains that the emission allowance costs that Apco seeks to recover through the fuel factor are based in large part on the price the Company must pay to transfer allowances from its sister operating companies under the Interim Allowance Agreement ("IAA").[6] Staff contends that, under the IAA, the majority of the AEP system cost of compliance (*i.e.*, the AEP system's total cost to reduce its SO_2 emissions) represents the installation of new plant at various AEP units. Staff states that these costs include,

---

[5] *Commonwealth of Virginia, ex rel. State Corporation Commission, Ex Parte, in re: Investigation to determine appropriate tariffs pursuant to Code § 56-249.6 for electric utilities which purchase fuel for generation including: Virginia Electric and Power Company, The Potomac Edison Company, Appalachian Power Company, Delmarva Power and Light Company of Virginia, Potomac Electric Power Company, and Old Dominion Power Company*, Case No. 20068-79/80 (PUE790010), Order Prescribing Rates to Recover Fuel Costs by The Potomac Edison Company, 1979 S.C.C. Rept. Ann. 338, 344.

[6] The IAA established the methodology for transferring pricing allowances among the operating companies of the American Electric Power Company ("AEP"), Apco's parent company. AEP has five operating companies, including Apco, referred to as "member companies." The other four member companies are: Kentucky Power Company, Ohio Power Company, Columbus and Southern Power Company, and Indiana and Michigan Power Company.

for example, the costs of adding scrubbers at Gavin units 1 and 2, a truck unloading facility at Muskingum unit 5, and the cost of building a new barge unloading facility at Kammer units 1 through 3. Staff contends that the costs associated with the system cost of compliance should not be recovered as fuel costs through the fuel factor, but as capacity costs in base rates, the same way all other plant costs are recovered.

The Committee filed a Post-Hearing Brief in which it urges the Commission to reject Apco's proposal to include SO_2 emission allowance costs in its fuel factor. The Committee contends that such costs are not fuel costs, pointing out that the coal is the fuel and the sulfur is the contaminant. The Committee points out that the Commission adopted definitional frameworks for each electric utility in Virginia that sought to recover fuel costs pursuant to § 56-249.6, and that, while these definitional frameworks have evolved slightly over time, none of them has allowed the inclusion of extraneous, non-fuel costs. The Committee notes, like Staff, that the Commission has determined that the costs of calcilox and lime used in the process of "scrubbing" sulfur during the combustion process was rejected as a fuel cost.[7] The Committee states that other electric utilities in Virginia have experienced pollution abatement expenses since Phase I SO_2 reductions began in 1995, and when these utilities incurred SO_2 allowance costs, they recovered such costs through their base rates. The Committee also contends that the capping of Apco's base rates under the Stipulation did not contemplate that Apco would be permitted to shift historically non-fuel costs out of base rates to enhance base rate earnings.

With respect to issues other than that of SO_2 emission allowance costs, the Committee states that, with the capacity that AEP will have available by the end of this year, AEP may experience a great increase in off-system sales and, hence, a great increase in margins. The Committee observes that if the Company does not file a base rate case by the end of this year, AEP's ratepayers will not receive any of the benefit of the incremental growth in sales. The Committee suggests that the Commission require Apco, in its 2001 fuel factor case after the Plan

[7] The Committee Post-Hearing Brief at 2, citing *Ex Parte: in re: Investigation to determine appropriate tariffs pursuant to Va. Code § 56-249.6*, 1979 S.C.C Ann. Rept. 338, 344.

Period ends, to change the Definitional Framework to return all or part of off-system sales margins to the deferred fuel account.

Finally, the Committee urges the Commission to establish a proceeding that will include a hearing, pre-filed testimony, and discovery, to consider whether Apco made every reasonable effort to minimize replacement fuel costs incurred as a result of the extended outages of the Cook nuclear units that began in 1997 and are expected to end in 2000. The Committee recommends that this matter be investigated before the final audit reports for fuel expenses are concluded for the years 1997-2000.

NOW THE COMMISSION, having considered the record, Staff's and the parties' comments and briefs, and the relevant statutes and regulations, is of the opinion and finds that Apco's request to include the cost of SO_2 emission allowances in its fuel factor should be denied.

Apco argues that emission allowance costs serve a fuel-like function and therefore should be treated as a cost of fuel that may be included in the fuel factor. We are not persuaded by the Company's arguments.

Emission allowance costs simply are not fuel costs. The costs of emission allowances are not a physical fuel and they are not physical substances consumed in the generation process. It should be noted that companies incur other costs that are similarly tied to the cost of coal for which the Commission has not permitted fuel clause recovery. As Staff and the Committee noted, the Commission has refused to allow the costs of limestone and calcilox to be included in another company's fuel factor, and these are physical substances that are used to remove SO_2 from flue gas stack emissions from some generating units and are consumed in proportion to fuel burned. Additionally, there are costs of fossil fuel-related variable expenses, such as fuel handling and fuel analysis, that are just as closely related to fuel as emission allowances and also vary in proportion to the amount of fuel burned, that companies are not allowed to recover through the fuel factor.

We agree with Staff that SO_2 emission allowance costs are costs that the Company incurs to comply with environmental regulations. Staff states, and the Company does not dispute, that

the allowance costs Apco seeks to recover through the fuel factor are largely based on the AEP system cost of compliance, and that the majority of the AEP system cost of compliance represents the installation of new plant at various AEP units. Staff further states that the system costs of compliance include, for example, the costs of adding scrubbers, a truck unloading facility, and a barge unloading facility. These are capital costs that should be recovered through base rates like all other plant costs.

Since we have decided this matter on the basis that the costs of emission allowances are not fuel costs, we do not decide the other issues raised by the parties, including the issue of whether the Stipulation bars a revision of the Company's Definitional Framework.

We also will address the Committee's request that a proceeding be established to consider whether Apco made every reasonable effort to minimize replacement fuel costs incurred as a result of the extended outages of the Cook units. We find that the Committee's request is reasonable and will direct the Company to include, in its next fuel factor application, a report identifying the sources and the incremental costs of replacement energy purchased as a result of those outages. If Cook Unit # 1 is not brought back on line from its extended outage by the time the Company files said application, the Company shall file such report in the form of a supplement to that application within 45 days of the date that Unit # 1 becomes operational.

Finally, with respect to the Committee's request that the Definitional Framework be revised to apply all or part of the off-system sales margins to the deferred fuel account, we note that, historically, the Company's customers have received some portion of the benefits of AEP's off-system sales through lower base rates. Therefore, a change in the manner in which the Company's customers receive such benefits is an issue that is properly raised in a base rate change application.

Accordingly, IT IS ORDERED THAT:

(1) The Company's request to include the costs of SO_2 emission allowance in its fuel factor is denied.

(2) The zero-based fuel factor of 1.339¢/kWh established by Commission Order of

November 8, 1999, shall remain in effect.

(3) The Company shall file, as part of its next fuel factor application, a report detailing the sources and the costs of incremental net replacement power associated with the extended outages of the Cook units, as discussed in the body of this order.

(4) This matter is continued generally.